Modification of Fiduciary Duties in Limited Liability Companies

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Table of Contents

I. Introduction 5
II. The Traditional Fiduciary Duties 5
III. Creation of Fiduciary Duties in Closely Held Business Organizations 6
  A. General Partnerships 6
  B. Domestic Corporations 6
  C. LLCs 7
IV. Expanding, Restricting, and Eliminating Fiduciary Duties in LLCs 8
V. Operating Agreement Drafting Suggestions 9
VI. Conclusion 9
VII. Endnotes 10

Modification of Fiduciary Duties in Limited Liability Companies

I. Introduction

Many commercial disputes involving Limited Liability Companies ("LLCs") arise from allegations of breach of fiduciary duties from those within the business. Typically, the structuring of the organization, done through an LLC's articles of organization and operating agreement, is of utmost importance in establishing the relationships among the parties within the entity and to the entity. Generally, fiduciary duties arise from those relationships, although they also can be implied by law. However, a dispute between or among members and/or managers of an LLC does not always follow a typical path. By agreement, parties can alter certain duties in order to expand, restrict or eliminate fiduciary duties owing to either the LLC or the other members and managers, so that the business fits expectations and needs. Any modification must be performed in accordance with the LLCs' state authorizing statute, which may limit what duties can be modified. Finally, in elimination or "exculpation" of fiduciary duties, some states mandate that provisions be made in the LLC's written operating agreement and that the provisions be set forth "clearly" and "unambiguously" in order to be upheld and/or not be rendered void by courts as a matter of public policy.

II. The Traditional Fiduciary Duties

Accountability and liability are vital issues to consider when determining what kind of business entity would best suit a particular business model or venture. If an officer, director, partner, or member makes a poor business decision or wants to pursue other opportunities outside of the business entity, what liability can they face from others in the business, or from the business itself? What duties are owed to the business by the officers, directors, or members? Most importantly, how are officers, directors, partners, or members able to protect themselves from liability?

Fiduciary duties in the closely held business context are duties owed to a business entity and to its shareholders or other members by those in positions of power or trust within the entity. Most people probably believe that fiduciary duties are an inherent responsibility assumed by the leaders of the business entity, but that is not strictly the case. Fiduciary duties can either be imposed by statute or created by the circumstances underlying a relationship as judged through common law jurisprudence. The most common fiduciary duties in the business context fall into three categories: the duty of loyalty, the duty of care, and the duty to act in good faith.

The fiduciary duty of loyalty requires that fiduciaries be loyal to the business entity or persons with whom they have a fiduciary relationship. Breaching the duty of loyalty usually occurs when the fiduciary fails to act for the benefit of the entity and instead acts for his or her own benefit by usurping opportunities that could have benefitted the corporation, using the corporation's information against it or for the fiduciary's benefit, or otherwise engaging in transactions via the corporation that benefit the fiduciary without the other officers', directors', or members' approval.

The fiduciary duty of care requires that directors, officers, or managers act with the care of an ordinarily prudent person in a like position and under similar circumstances. In other words, act as an ordinarily prudent director, officer, or manager would act in those circumstances. In the corporate context, directors and officers enjoy the benefit of a presumption called the business judgment rule if it is alleged that they have violated their duty of care. The business judgment rule, provided by either a state corporation law statute or by common law, creates a presumption that the director or officer acted in good faith, on an informed basis, and in the honest belief that the decision was in the best interest of the company, and the burden of proving otherwise is on the complainant. Thus, the presumption is a powerful shield and defense against accusations of care violations. The presumption is so strong that fiduciaries are rarely found prima facie liable for a breach of their duty of care.

Finally, a fiduciary must act with good faith, not in a fraudulent way, with honesty of purpose, and in the best interest and welfare of the corporation. The duty of good faith is often thought of as another component in, or a subset of, the duty of loyalty.

III. Creation of Fiduciary Duties in Closely Held Business Organizations

What fiduciary duties are imposed and which fiduciary duties can be modified can depend on the type of entity under which the fiduciary is acting.

A. General Partnerships

Under common law, a partnership can be created simply by two (2) or more people carrying on business for profit. Thus, the formation requirements for creating a partnership are minimal. However, a business organized as a general partnership subjects all partners to joint and several liability for debts and obligations of the partnership, while having the benefit of pass-through taxation. For fiduciary duties, generally, partners must always place the interest of the partnership above their own personal or business interests. "Under common law, general partners owe each other and the partnership fiduciary duties until final termination of the partnership … This fiduciary relationship between partners requires each partner to exercise good faith and fair dealing in partnership transactions and toward co-partners." *In re Rueth Dev. Co.*, 976 N.E.2d 42, 53 (Ind. Ct. App. 2012) (citation omitted). In addition, partners have the obligation to fully disclose to other partners any information relating to the partnership that could affect a partner's material interest. Partnership agreements can be structured to modify and in some states eliminate fiduciary duties, but all changes must be reasonable and be made in good faith.

B. Domestic Corporations

A domestic corporation can be an attractive business model for those who want to limit their liability and maintain the corporation as a separate business entity. Corporations, however, are inherently creatures of state statutes, with many formalities that must be met in order to successfully incorporate. In addition, corporations are subject to dual taxation. The corporation is taxed on its profits, and if profits are distributed as dividends, then the profit is taxed again. Corporations are wholly owned by shareholders, but they are operated by a separate management that is accountable to the corporation and stockholders. Unless the corporation is closely held, stockholders do not generally owe any duties to each other. Under the Model Business Corporations Act ("MBCA"), even though the duties of loyalty and care are imposed, directors can be exculpated for some breaches of the duty of care, but not breaches of the duty of loyalty, in the corporation's articles of incorporation. MBCA §2.02(b)(4). In addition, under the MBCA directors are not liable to the corporation or to shareholders for any decision unless the conduct was not in "good faith," a decision which the director did not "reasonably believe to be in the best interests of the corporation" or as to which the director was not "informed to an extent the director reasonably believed was appropriate in the circumstances." MBCA §8.31.

Closely held corporations have been held to a higher standard in the imposition of fiduciary duties. Fiduciary standards in closely-held corporations are similar to the fiduciary standards of partnerships because shareholders, officers, and directors are often all the same people when the corporation is closely-held as opposed to a public corporation, where ownership and operation of the corporation are more distinct. *See Maul v. Van Keppel,* 714 N.E.2d 707 (Ind. Ct. App. 1999); *Schumacher v. Schumacher*, 469 N.W.2d 793 (N.D. 1991); *McLaughlin v. Schenk*, 220 P.3d 146 (Utah 2009); *Walta v. Gallegos Law Firm, P.C.*, 40 P.3d 449 (N.M. 2002); *Lawton v. Nyman*, 327 F.3d 30 (1st Cir. 2003); *Rexford Rand Corporation v. Ancel,* 58 F.3d 1215 (7th Cir. 1995). A potential notable exception is California, where in an unpublished decision the Ninth Circuit predicted that fiduciary duties owed are the same no matter the nature of the corporation. *Merner v. Merner*, 129 F. App'x 342 (9th Cir. 2005). Further, Texas courts have held that a co-shareholder does not as a matter of law have a fiduciary duty to the other shareholder, but rather the creation of a duty depends on circumstances. *Pabich v. Kellar*, 71 S.W.3d 500 (Tex. App. 2002). Delaware is very strict in its application of fiduciary duties; a company must be a statutory closely held corporation for any special rules to apply. *Nixon v. Blackwell*, 626 A.2d 1366, 1381 (Del. 1993).

C. LLCs

Borrowing from abroad, the state of Wyoming enacted the first LLC act in 1977. An LLC has advantages that other business entities do not, primarily pass-through taxation and limitation of personal liability for business debts, but also the ability to modify the form of the business including modification of fiduciary duties. In 1996, the National Conference of Commissioners on Uniform State Laws enacted the Uniform Limited Liability Company Act ("ULLCA") to take into consideration the then relatively new form of unincorporated business organizations. At that time, LLCs were becoming a significant factor in non-publicly traded markets and mergers, and nearly every state had adopted some form of LLC statute.

Under the ULLCA, an LLC could be member-managed or manager-managed as provided in an LLC's articles of organization. *See* ULLCA §203. A "member" of an LLC is usually provided for in the operating agreement of the LLC, though there are other methods by which a person can become a member. *Id*. By statutory default under the ULLCA, members owe fiduciary duties of loyalty and care to each other and the company. ULLCA §409. Under subsections (b)(2) to (4), an irreducible core of fiduciary responsibilities survive any contrary provision in the operating agreement. ULLCA §103. In a member-managed LLC, "the management and conduct of the company are vested in the members," and members have equal rights, but the company has a legal existence separate from the membership. ULLCA §404(a). In a manager-managed LLC, the company is run exclusively by the manager or managers and not necessarily the members. ULLCA §404(b). A "Manager" is a person or persons chosen by the members to run the LLC. *Id*. Generally, for fiduciary duties under the ULLCA, managers and members can modify the statutorily imposed fiduciary duties of loyalty and care owing to the LLC and to the other members but only in a limited fashion. The ULLCA (and case law interpreting it) does not provide for complete elimination or waiver of fiduciary duties.

The "second generation" 2006 Revised Uniform Limited Liability Company Act ("RULLCA") took into account nearly a decade of developments in the field and created a comprehensive, fully-integrated LLC statute. One significant change in the RULLCA concerns the extent to which the operating agreement can define, alter or eliminate aspects of fiduciary duties and liabilities of members and managers of an LLC. The RULLCA states that a member of a member-managed LLC owes a duty of loyalty and care to the LLC and other members. RULLCA §409. However, these duties can be limited. RULLCA §105(d) provides that the operating agreement may "specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts." Further, if not manifestly unreasonable, it may "alter or eliminate the aspects of the duty of loyalty stated in §409(b) and (i)…identify specific types or categories of activities that do not violate the duty of loyalty… alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law; and…alter or eliminate any other fiduciary duty." The RULLCA provides members of an LLC with the practical ability to eliminate most liability for the duties of loyalty and care. The RULLCA's scope is broader than the more limited exculpation allowances of the MBCA. This reflects the Commission's intention that those who choose the LLC business organization model should be allowed more freedom of contract to modify or eliminate their fiduciary duties as members believe is necessary.

IV. Expanding, Restricting, and Eliminating Fiduciary Duties in LLCs

Currently, only seventeen (17) states (and the District of Columbia) have adopted the RULLCA[1] in some form, meaning a majority of states still follow the older ULLCA or have codified a state-specific LLC act. Because of the wide discrepancy of statutory law, expanding, restricting, and eliminating fiduciary duties can be difficult for structuring of LLCs when drafting operating agreements. For example, Indiana has its own unique LLC Act, adopted in 1993 entitled "the Indiana Business Flexibility Act." Ind. Code Art. 23-18-2. In Indiana, members and managers may "[m]odify, increase, decrease, limit, or eliminate the duties (including fiduciary duties) or the liability of a member or manager for breach of the duties" in a written operating agreement. Ind. Code §23-18-4-4; *see also Purcell v. Southern Hills Investments, LLC*, 847 N.E.2d 991, 996 (Ind. Ct. App. 2006); *Credentials Plus, LLC v. Calderone*, 230 F. Supp. 2d 890, 898 (N.D. Ind. 2002). In 2011, the Indiana Business Law Survey Commission studied whether Indiana should adopt the RULLCA, but found that "whole cloth enactment … [was] not desirable at this time."

In Washington, the default standard is that members do not owe any duties to other members unless an act or omission constitutes gross negligence, intentional misconduct or a knowing violation of the law. *See* Wash. Rev. Code §25.15.038. In Kansas, a dispute arose between members of an LLC when other members acquired business opportunities of the LLC rather than turning them over to the LLC. *See Lynch Multimedia Corporation v. Carson Communications, L.L.C.*, 102 F. Supp. 2d. 1261 (D. Kan. 2000). In *Lynch*, the members' operating agreement provided that "Any Member or Manager may engage independently or with others in other business ventures of every nature and description." *Id.* at 1263. The Kansas court confirmed that members of an LLC may expand or restrict their fiduciary duties by agreement. *Id.* at 1265.

The states of Missouri, Delaware, North Carolina, and Nevada have also held that common law fiduciary duties can be modified in operating agreements. *Wood v. Baum*, 953 A.2d 136 (Del. 2008); *Hibbs v. Berger*, 430 S.W.3d 296 (Mo. Ct. App. 2014; *Kaplan v. O.K. Technologies, L.L.C.*, 675 S.E.2d 133 (N.C. Ct. App. 2009); and *JPMorgan Chase Bank*, *N.A. v. KB Home*, 632 F. Supp. 2d 1013 (D. Nev. 2009). Courts in Arizona and Virginia have rejected the common law imposition of duties because they have interpreted their LLC Acts to provide for how LLCs should be treated, and not the courts. *See TM2008 Investments, Inc. v. Procon Capital Corp.*, 323 P.3d 704, 708 (Ariz. Ct. App. 2014); *WAKA, LLC v. Humphrey*, 73 Va. Cir. 310 (2007).

Elimination or "exculpation" of fiduciary duties in operating agreements of LLCs is relatively common in practice, but has been met with varying results from courts. In *McConnell v. Hunt Sports Enterprises*, an LLC was formed for the purpose of investing in and operating a professional hockey franchise under the National Hockey League. 132 Ohio App.3d 652, 725 N.E.2d 1193 (1999). Several members of the LLC refused to agree to the terms offered by an entity to build an arena. Fearing the city would lose out on the franchise, one of the members agreed to individually accept the terms for the arena. A competition provision in the LLC's operating agreement stated: "Member shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business or venture of any nature, including any venture which might be competitive with the business of the Company." *Id.* at 1206. The court held that members were not prohibited from engaging in competitive business with the LLC, because the provision was "plain and unambiguous" in permitting competition against the LLC and other members. *Id*. Similarly, in *Stoker v. Bellemeade*, the members of an LLC exercised the freedom of contract granted by the Georgia LLC Act. 615 S.E.2d (Ga. App. 2005), *reversed on other grounds Bellemeade v. Stoker*, 631 S.E.2d 693 (Ga. App. 2005). The court found that the members' agreement allowed them to engage in activities that competed with the LLC's business. *Id*.

On the other hand, the Delaware Court of Chancery found that language in a partnership agreement failed to clearly preclude the application of the fiduciary duty of loyalty in *Miller v. American Real Estate Partners L.P.*, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001). The court noted that given the great freedom afforded to drafters of such agreements, it is fair to expect that restrictions on fiduciary duties be set forth "clearly and unambiguously." *Id*. at *8. "[T]he Partnership Agreement preserves that core aspect of the duty of loyalty which prohibits a fiduciary from taking bad faith action to injure the Partnership for his own personal advantage." *Id*. at 11. Although in the context of a partnership agreement, *Miller* has been applied to LLCs and is a great example of the pitfalls to avoid when drafting LLC operating agreements.

V. Operating Agreement Drafting Suggestions

In modification of fiduciary duties in an LLC's operating agreement, members and managers can and should ensure their understanding is reflected onto the business by following a few simple drafting suggestions. First, determine what duties are implied through your state's authorizing statute and what duties are implied through common law jurisprudence. Second, clearly state what duties are being modified or eliminated, or under what circumstances an activity is not a violation of a duty of loyalty. However, this should be done only to the extent your state allows. Third, an exculpation clause in an operating agreement should be as specific and unambiguous as possible. Clearly and explicitly specify if the parties have agreed to eliminate fiduciary duties or have contracted them away by omission. Below is a sample provision[2] eliminating fiduciary duties:

> "Notwithstanding any other provision of this Agreement, to the extent that, at law or in equity, the Manager or any other Indemnitee would have duties (including fiduciary duties) to the Company, to any Member, to any Person who acquires an interest in the Company or to any other Person bound by this Agreement, all such duties (including fiduciary duties) *are hereby eliminated, to the fullest extent permitted by law*, and replaced with the duties expressly set forth herein."

As you can see, this provision clearly and explicitly identifies and excludes fiduciary duties owing to "the Company, to any Member, or any Person who acquires an interest." The provision clearly indicates all fiduciary duties are "herby eliminated to the fullest extent permitted by law." Because it only applies "to the fullest extent permitted by law," it would likely not be void as against public policy but would change depending upon the jurisdiction. Finally, a drafter could either "replace" the eliminated fiduciary duties with other specifically defined duties owing, or could simply leave them eliminated.

VI. Conclusion

LLCs are attractive to many because they adopt the positive characteristics of the partnership and corporation business forms while cutting out the negative aspects of both. In other words, a LLC is a hybrid entity that enjoys the best of both worlds. Members of a LLC are treated in a similar way as partners, and the LLC itself is treated as a partnership for tax purposes, enjoying pass-through taxation. Finally, in some states, due to these shared characteristics, an LLC may construct an operating agreement that clearly and unambiguously preempts the duties of loyalty, care (barring intentional misconduct), and the duty to act in good faith among members and mangers of the LLC.

VII. Endnotes

[1] The RULLCA states are: Alabama (ALA. Code § 10A-5A-1.01 (2014)), California (Cal. Corp. Code § 17701.01 (2014)), Connecticut (Conn. Gen. Stat. § 34-243 (2017)), District of Columbia (July 2, 2011, D.C. Law 18-378, § 2, 58 DCR 1720), Florida (Fla. Stat. § 605.0101 (2014)), Idaho (Idaho Code § 30-21-101 (2015)), Iowa (Iowa Code § 489.101), Minnesota (Minn. Stat. § 322C.0101 (2017)), Nebraska (Neb. Rev. Stat. § 21-101(2010)), New Jersey (NJ Stat. Ann. § 42:2C-1), North Dakota (N.D. Cent. Code § 10-32-01), Pennsylvania (15 Pa. Cons. Stat. § 8811 (2016)) South Dakota (2011 S.D. Codified Laws § 47-34A-1001), Utah (Utah Code Ann. 48-3a-101 (2013)), Vermont (Vt. Stat. Ann. tit. 11, § 4001 (2015)), Washington (Wash. Rev. Code § 25.15.011 (2015)), and Wyoming (Wyo. Stat. Ann. § 17-29-101 (2015)).

[2] *See* Benyamin S. Ross & Melissa K. Studenberg, *Gibson Dunn & Crutcher* and *Richards Layton & Finger*, STRUCTURING LLC OPERATING AGREEMENTS: CRAFTING FIDUCIARY DUTY, INDEMNIFICATION, AND EXCULPATION PROVISIONS 32-33 (Strafford Continuing Legal Education, February 2, 2017).